Information Note for LegCo Panel on Financial Affairs

Policy Initiatives of the Financial Services and the Treasury Bureau

Introduction

This information note elaborates on the new and on-going policy initiatives relating to the Financial Services and the Treasury Bureau under the 2008-09 Policy Agenda issued on 15 October 2008.

Financial Services

Overview

2. In the past months, the global financial markets have been deeply affected by a weakening of market confidence in the soundness and capability of the financial systems to effectively respond to the aftermath of the subprime crisis. This is reflected in volatile market movements and a heightened concern among regulatory authorities worldwide to closely monitor risk exposure of their regulated entities and to strengthen the financial systems in the light of the changing market landscape.

3. In Hong Kong, we have been placing great emphasis on upholding a robust regulatory regime by maintaining effective prudential oversight of our financial institutions. Our regulatory framework is kept in line with the latest international standards. For example, Hong Kong is among the first jurisdictions to adopt the risk-based capital adequacy standards for the banking industry enshrined in Basel II starting from January 2007. Over the years, we have also put considerable efforts to promote good corporate governance practices in Hong Kong, central to which are proper risk management and internal controls. As a result, although our financial markets are unavoidably affected by the repercussions of the subprime crisis and the adverse sentiments arising therefrom, our financial system has remained stable and has displayed resilience in coping with the challenges. The Government and the regulators will continue to exercise vigilance to ensure effective functioning of our financial system.

4. As at end August 2008, our stock market was the 6th largest in the world and the 2nd largest in Asia in terms of market capitalization. Hong Kong ranked fourth globally in terms of funds raised in initial public offerings. It continued to provide a preferred platform for the listing of quality Mainland enterprises and for overseas investors to tap the development potential of the Mainland economy. About 70 of the world's 100 largest banks operated in Hong Kong. The Mandatory Provident Fund Schemes continued to expand in size with a total net asset value of HK$244.59 billion.

5. Compared to 2006, our combined fund management business had increased by 56.5% to reach HK$9,631 billion in 2007. For the 8th year in a row, the insurance industry recorded double-digit growth in total gross premiums, which amounted to HK$200 billion in 2007.

6. In the coming year, we will make new efforts to strengthen our regulatory regime and enhance protection of depositors and investors to take account of the risks to market stability as exposed in the subprime crisis. We will work towards strengthening the supervisory framework for authorized institutions (AIs) in the banking industry as well as the anti-money laundering (AML) and counter financing of terrorism (CFT) regime in Hong Kong. We will also review the coverage and protection limit of the Deposit Protection Scheme, and examine the development of a policyholders' protection fund with a view to providing better protection to depositors and insurance policyholders. We believe that these are important steps to bolster confidence of depositors and investors in our financial system and to consolidate our leading position as an international financial centre in the region.

7. Moreover, we will press ahead with on-going efforts to promote market development. Considerable progress has been made in the past year to promote the development of Islamic finance and to advance financial services cooperation with Mainland China. For instance, the Hong Kong depositary receipts (HDRs) which provide an alternative facility for issuers to list on the Stock Exchange of Hong Kong (SEHK) was introduced in July 2008. In the coming year, we will continue to vigorously implement market development initiatives to capitalize on the new opportunities in the region and around the world.

2008-09 Policy Agenda

8. We set out below the progress and upcoming plans in connection with our major policy initiatives which are aimed at two main areas, namely, promoting market development and improving market quality.

I. Promoting Market Development

(a) Advancing financial cooperation with the Mainland

9. We have been continuing to advance financial co-operation with the Mainland. Our aim is to develop a mutually-assisting, complementary and interactive relationship between the two financial systems.

10. In the past year, we have worked towards expanding the presence of Hong Kong financial institutions, such as banks, fund management and insurance companies, on the Mainland under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). In response to suggestions from our banking industry, a new measure has been introduced under Supplement V to CEPA[1], whereby Mainland-incorporated banking institutions established by Hong Kong banks are allowed to locate their data centres in Hong Kong, subject to fulfilment of certain requirements. For the banks concerned, this allows flexibility in providing information technology support to their businesses in Hong Kong, the Mainland and other geographical areas through their regional data centres in Hong Kong. A single-location arrangement may also help reduce the operational and technology-related risks involved. More importantly, this signifies the confidence of the Mainland authorities in Hong Kong's legal, regulatory and technical infrastructure in this aspect.

11. Apart from the above, we have encouraged Mainland funds, investors and financial institutions to go overseas through Hong Kong by way of the Qualified Domestic Institutional Investors (QDII) Scheme. The implementation of the Mainland QDII Scheme in 2007 brought about tremendous business opportunities for the fund management industry. The first QDII fund was launched in September 2007, and so far, Hong Kong has been one of the preferred investment markets for QDII funds. The QDII Scheme has provided an additional source of inflow for the fund management business in Hong Kong. According to the latest results of the annual Fund Management Activities Survey conducted by Securities and Futures Commission (SFC), a total of HK$130 billion of assets were sourced from the QDII Scheme.

12. At the same time, we are studying in collaboration with the Mainland on how to strengthen the links of the two financial markets. With our strengths at the retail and wholesale levels, Hong Kong is able to offer customized wealth management services and innovative products to investors in

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[1] All the service liberalization measures under Supplement V to the CEPA will come into force on 1 January 2009.

the Mainland. Under Supplement IV to the CEPA which became effective on 1 January 2008, Mainland fund management companies can apply to set up offices in Hong Kong. This arrangement allows Mainland fund managers to access international markets and practices via Hong Kong.

13. Another notable achievement in fostering closer financial links with the Mainland is the continuous expansion of Renminbi (RMB) business in Hong Kong. RMB business in Hong Kong has developed steadily since its launch in 2004, with its scope further expanded in 2005 and 2007. In June 2007, the first RMB bond in Hong Kong was successfully launched, making Hong Kong the first and the only place outside the Mainland that possesses a RMB bond market[2]. Subsequent to the three successful RMB bond issues (RMB10 billion in total) in 2007, there has been another four RMB bond issues so far in 2008, raising a further RMB12 billion. As at end August 2008, RMB deposits amounted to RMB71.1 billion, with a total of 1 186 717 RMB accounts. Forty retail banks in Hong Kong offer RMB banking services. We will continue to ensure the smooth operation of RMB business and pursue further expansion of the scheme. In this regard, discussion with the relevant Mainland authorities on a proposal for Hong Kong importers to settle import trade from the Mainland in RMB is in progress.

14. At the regional level, we are looking into areas of possible closer cooperation which can be implemented in Guangdong on a pilot basis under the framework of Hong Kong/Guangdong Cooperation Joint Conference (HKGDCJC). The Secretary for Financial Services and the Treasury will lead a delegation to Guangzhou on 20 October 2008 to attend the Financial Cooperation Seminar.

(b) Broadening the source of listed companies

15. Following the publishing of a joint policy statement by the Hong Kong Exchanges and Clearing Ltd (HKEx) and the SFC in 2007 to facilitate overseas companies in seeking a primary listing in Hong Kong, the HKEx has been stepping up efforts in promoting Hong Kong as a preferred listing venue. During 2008, HKEx has conducted a series of marketing visits to the Mainland and overseas jurisdictions, including India, Mongolia, the United States, Canada and Russia, etc. Furthermore, HKEx has introduced a framework for issuers to

[2] To support issuance and trading of RMB bonds and to ensure that the RMB bonds can be settled in Hong Kong in a safe and efficient manner, the Hong Kong Monetary Authority has established a RMB Real Time Gross Settlement system and expanded the clearing and settlement facilities at the Central Moneymarkets Unit to cover RMB debt securities. The infrastructure also facilitates the development of a repo market, and retail investors can use RMB cheques or bank transfers to settle payments relating to the subscription and trading of RMB bonds.

list in Hong Kong through HDRs with effect from July 2008, which helps to diversify and enhance the competiveness of Hong Kong's listing platform.

(c) ***Developing the Islamic bond (sukuk) market***

16. Following the 2007-08 Policy Address, in which a proposal of developing Islamic finance in Hong Kong was put forward, the Government has been making active efforts to put in place a conducive platform for sukuk in Hong Kong.

17. On the understanding that there are no fundamental difficulties for the development of a sukuk market as far as our legal and regulatory systems are concerned, we are conducting a review on our taxation regime to identify necessary modifications that need to be made to address the likely tax issues such as additional stamp duty and profits/property tax implications arising from the more complicated structures of sukuk as compared with those of conventional bonds. Before the modifications to our tax regime are made, we will consider providing necessary tax concession to sukuk issuance and other Islamic financial products to be launched in Hong Kong on the principle of ensuring a level playing field for Islamic financial products vis-à-vis conventional ones.

(d) ***Promoting asset management business***

18. In May 2008, the China Securities Regulatory Commission announced new measures which allowed qualified fund management companies in the Mainland to set up operations in Hong Kong under CEPA. This will bring more Mainland fund management companies to Hong Kong, hence enhancing the breadth of our financial intermediary base and facilitating the development of Hong Kong into a premier wealth management centre for Mainland investors. Looking ahead, the Government and our financial regulators will continue to promote Hong Kong's asset management industry and enhance our position as a major asset management centre in Asia.

(e) ***Developing Hong Kong's commodities futures market***

19. The robust performance of the Mainland economy in recent years has led to increasing demand for risk management in respect of commodity prices, which presents potential for Hong Kong to develop commodity futures and other related derivative products. In this connection, the SFC has authorized the first exchange traded fund which tracks the price of gold for listing on the SEHK earlier this year. In the coming months, the HKEx will launch cash-settled gold futures contracts and will continue to explore the

launching of emissions-related products in Hong Kong. At the same time, SFC will continue to work with potential market operators in studying the feasibility and way forward for the development of Hong Kong's commodities futures market.

(f) Promoting bond market development

20. We are committed to enhancing the breadth and depth of our bond market and encouraging more local and international issuers to use our bond issuance platform. The Hong Kong Monetary Authority (HKMA) has successfully launched an electronic trading platform for Exchange Fund Bills and Notes in end 2007. It will continue to enhance the Exchange Fund Bills and Notes Programme by suitably adjusting the maturity profiles of the Exchange Fund Bills and Notes and promoting the use of the electronic trading platform for the Exchange Fund Bills and Notes. In addition, in early 2008, the HKMA completed Phase 2 of the review of debt market development, which covered broader issues beyond the ambit of the HKMA. A number of recommendations are now being taken forward by the Government:

- to further streamline and shorten the turn-around time for listing of debt securities;
- to review the investment guidelines of government and public funds with a view to removing unduly restrictive guidelines, especially on easing the cap for exposure to a single issue;
- to review the requirements for granting tax concessions for QDIIs; and
- to work with investment community to lobby the benchmark setters for including Hong Kong dollar bonds in the benchmark indices.

(g) Promoting Hong Kong's position as an international financial centre

21. In the past year, the Financial Secretary and the Secretary for Financial Services and the Treasury have been leading delegations to the Mainland and overseas, e.g. India, Vietnam, the United States, Russia, etc, to showcase Hong Kong's position as an international financial centre. We will continue with these promotional efforts to identify new development opportunities and foster closer cooperation relationship with other places in the world.

II. Improving Market Quality

(a) Regulatory reform

22. A sound and effective regulatory regime is of paramount importance in maintaining investor confidence and our standing as a pre-eminent financial centre. In response to the recent issues pursuant to the collapse of Lehman Brothers, the HKMA and the SFC will submit reports to the Financial Secretary, by end of 2008, on their observations, lessons learned and issues identified during the process of investigating the relevant complaints they have received. Upon receipt of their reports, we will undertake a full and comprehensive systemic review and to consider, on a policy level, what can be done to further improve our regulatory regime and to enhance investor protection and education.

23. In addition, we will launch new initiatives this year to strengthen our regulatory regime to take into account the latest operational experience and market development, as well as evolving international standards. The new policy initiatives and progress of on-going initiatives are highlighted in the paragraphs below.

i. Strengthening supervisory framework for banks

24. Although the recent market turmoil has had limited impact on the Hong Kong banking system, the HKMA considers it important to review and strengthen the supervisory framework for AIs in order to ensure their resilience to withstand severe market stress and to reinforce Hong Kong's role as an international financial centre. In line with the recommendations made by the Financial Stability Forum, the Basel Committee on Banking Supervision and other international organisations based on the lessons of the recent turmoil, the HKMA will develop and implement various supervisory responses to further enhance the existing supervisory framework and policy guidelines concerning the management and enhancement of capital treatment for structured credit and securitization activities, improvement to liquidity risk management and enhancement of risk management capabilities of AIs, particularly in respect of the use of stress test and monitoring the international developments on valuation and disclosure standards with a view to assessing the impact on our banking supervision policies.

ii. *Strengthening the AML and CFT regime*

25. As an international financial centre, Hong Kong should put in place an effective regime to deter criminals from making use of our financial and non-financial systems to launder criminal proceeds and/or finance terrorists. This is important for sustaining a conducive environment in fostering the growth of legitimate business and investment in Hong Kong. A Central Coordinating Committee on Anti-money Laundering and Counter Financing of Terrorism (CCC) chaired by the Financial Secretary has been set up earlier this year to steer the process of strengthening the AML and CFT regime in Hong Kong to ensure that it can meet the international standards.

26. The Financial Services and the Treasury Bureau has taken over from the Security Bureau the overall coordinating role for AML/CFT policies and will embark on a review of our financial systems and the relevant preventive measures, under the CCC's steer, with a view to strengthening the AML/CFT regime in Hong Kong by taking into account the recommendations made in the Financial Action Task Force Mutual Evaluation on Hong Kong conducted in November 2007.

iii. *Review of the Deposit Protection Scheme*

27. The Financial Secretary announced on 14 October the use of the Foreign Exchange Fund, on a special and time-limited basis, to guarantee the repayment of all customer deposits held with all AIs in Hong Kong with immediate effect. The guarantee extends to the end of 2010. In addition, the Hong Kong Deposit Protection Board will continue to review the coverage and protection limit of the Deposit Protection Scheme and provide feasible long-term proposals in order to enhance protection to depositors in the long run.

iv. *Enhancing the Mandatory Provident Fund System*

28. In the past year, two Amendment Bills to the Mandatory Provident Fund Schemes Ordinance (MPFSO) were enacted by the Legislative Council (LegCo) which bring significant improvements to the Mandatory Provident Fund (MPF) System through streamlining its operation, enhancing its efficiency and strengthening its enforcement for better protection of scheme members' interests. Examples of the major amendments include removal of the 30-day settlement period to facilitate early recovery of default contributions, imposition of criminal and civil liability on employers who failed to make MPF contributions in non-enrolment cases, and increasing the maximum penalty against employers for non-enrolment and default contributions.

29. On the other hand, a legal framework has been put in place to facilitate the Mandatory Provident Fund Schemes Authority's (MPFA) implementation of the budget proposal to inject $6,000 into MPF accounts of eligible MPF scheme members and MPF-exempted Occupational Retirement Scheme (ORSO Scheme) members. The MPFA has requested the MPF trustees, ORSO trustees and ORSO employers to provide scheme members' information by end October 2008 for compilation of a list of eligible persons. We expect to be ready to seek LegCo Finance Committee's funding approval in early 2009 and meet the target to commence injection of funds in 2008-09.

30. In addition, we are now preparing legislative proposals to enhance employees' control over their MPF investments. The proposals will help promote greater competition in the MPF market and encourage more active management of MPF investments by scheme members. We aim to introduce the Bill on the proposals in this legislative year.

v. *<u>Setting up of an independent Insurance Authority (IA)</u>*

31. We have commissioned a consultancy study to look into various key aspects of setting up an independent IA, including its governance structure, organisational framework, funding mechanism and budgetary system. The study is expected to be completed this year. We will prepare proposals for consultation with stakeholders next year after we have carefully examined the consultant's recommendations.

vi. *Development of a policyholders' protection fund*

32. As reported to the LegCo Panel on Financial Affairs in July this year, the Office of the Commissioner of Insurance (OCI) and the Hong Kong Federation of Insurers have been working closely together to examine possible options on the development of a policyholders' protection fund to maintain market stability and public confidence on the integrity of the financial system in the unlikely event of insolvency of an insurer. In the process, careful consideration will be given to the need to accord a proper balance between the scope of coverage, additional costs that might be passed on to consumers and moral hazard problems.

vii. *<u>Rewrite of the Companies Ordinance</u>*

33. The Companies Ordinance (CO) rewrite exercise has been generally on track since its commencement in mid-2006. During Phase I of the exercise, we will review the core company provisions that affect the operation of more than 690,000 live companies in Hong Kong. The Standing

Committee on Company Law Reform and four Advisory Groups comprising representatives from relevant professional bodies, major chambers of commerce, and company law academics have substantially completed their work. Meanwhile, we have launched three rounds of public consultation covering more complex subjects, including the accounting and auditing provisions, company names, directors' duties, corporate directorship, registration of charges, share capital, capital maintenance regime and statutory amalgamation procedure.

34. The consultation conclusions on the accounting and auditing provisions were publicised in March 2008 while those for the second and third rounds are planned to be issued by end 2008 and early 2009 respectively. A draft Bill incorporating public feedback from the above consultations will be produced for further public consultation around mid-2009 before the Companies Bill is introduced into LegCo tentatively, by the third quarter of 2010.

viii. *Review of the Trustee Ordinance*

35. We have started to review the trust law regime in Hong Kong with a view to modernising the provisions in the Trustee Ordinance (TO) for the purposes of strengthening the competitiveness of our trust services industry and facilitating the development of financial services market in Hong Kong. We are finalising the scope of the review taking into account the views of the trust practitioners, academics and financial regulators and will leverage on the recent reforms in other comparable common law jurisdictions including the United Kingdom and Singapore. We plan to conduct a targeted consultation in early 2009 and introduce the bill into the LegCo as soon as possible afterwards.

(b) ***Investor Protection***

36. Another key focus of our on-going efforts to improve market quality is enhancing investor protection, which is essential to the stability of our financial markets. In this connection, SFC has stepped up efforts in promoting investor education. For example, a dedicated investor education website and a monthly newsletter "Dr Wise" is being issued to increase the public's knowledge of topical investment issues. It also regularly organizes seminars and produces TV programmes on investor education.

37. The recent financial crisis whereby investors had bought products that they might not have fully understood has vividly highlighted the importance of investor education in maintaining a stable and healthy financial market. SFC will devote more resources to raise investors' awareness of their rights and the benefits and risks of investing, and will also keep in view the

regulatory framework and supervision of intermediaries to maintain market integrity.

Fiscal Policy

Fiscal Targets

38. In the 2008-09 Policy Agenda, we pledge to continue the strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of Gross Domestic Product. This is in line with the principle of keeping expenditure within the limits of revenue in our management of public finances. We will also continue to review our tax base and implement the asset sale and securitisation programme.

39. With the implementation of the one-off relief measures announced by the Chief Executive in July 2008, we forecast that the deficit for 2008-09 will be higher than the original estimate of $7.5 billion. We will continue to manage our public finances prudently and follow the principle of keeping expenditure within the revenue limits. At the same time, we will bear in mind Hong Kong’s long-term interest and prepare for future challenges including the uncertain economic environment and an ageing population.

Financial Services and the Treasury Bureau
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